Kapstream
—JANUS HENDERSON—

Kapstream Absolute Return Income Fund

Fund Objective

The fund aims to provide a superior stream of income and capital stability over the medium term while aiming to outperform its benchmark through market cycles.

Fund Application

Investors seeking to enhance their overall fixed income returns with a higher yielding, predominantly investment grade (IG), absolute return-oriented global fixed income portfolio.

Fund Details

APIR code	HOW0165AU
Inception date	31 May 2007
Fund size	AUD 1935.44
Distribution frequency	Quarterly
Management fee	0.40%
Buy/sell spread	Please contact us for latest spreads

Fund Statistics

Interest rate duration	1.12yrs
Credit spread duration	1.77yrs
Average credit rating	BBB+
No of issuers	70
Yield to maturity	6.21%

Fund Guidelines

Target return	cash plus 2-3%
Target volatility	less than 1.5% annualised
Duration limits	-2 to +2 years
Credit quality	>85% investment grade

Dan Siluk
Portfolio Manager

Dylan Bourke
Portfolio Manager

June 2024

Performance (%)	1 month	3 months	1 year	3 years p.a.	5 years p.a.	Annualised since inception.
Fund Return (before fees and sell spread)	0.70	1.66	6.87	3.13	2.60	4.58
Fund Return (after fees, before sell spread)[1]	0.66	1.55	6.41	2.70	2.16	4.22
Fund Return (after fees and sell spread)[2]	0.66	1.55	6.41	2.71	2.14	4.21
RBA Cash Rate	0.33	1.08	4.25	2.43	1.62	2.80
Active return[3] (before fees and sell spread)	0.37	0.59	2.63	0.70	0.98	1.78
Active return[3] (after fees and sell spread)[2]	0.33	0.47	2.16	0.28	0.52	1.41
Bloomberg AusBond Bank Bills Index	0.35	1.08	4.37	2.44	1.64	3.00

Past performance is no guarantee of future results. After fee returns are inclusive of 0.41% annualised total expenses for class I units. Fund inception date 31 May 2007. No allowance is made for tax. Numbers may not add due to rounding. 1) For a continuing investor the actual return experienced based on the NAV performance of the Fund, after accounting for management fees. 2) The return experienced by a redeeming investor, based on the exit price performance of the Fund which accounts for the end of period sell spread of 0.07% and management fees. 3) Active return of the Fund compared to Benchmark (RBA Cash Rate). Source: Fidante Partners Limited, 30 June 2024.

Performance Commentary

The Fund added a solid 0.66% in June, taking 12 month returns to 6.41% (after accounting for Class I unit fees). This strong performance was despite the re-emergence of some negative risks for fixed income in the month, in the form of French geopolitical concerns and RBA rate hike fears. The high running yield in the portfolio was the main driver of returns, reflecting not only the high level of underlying interest rates at present but the additional credit spread actively incorporated to boost returns. Falling bond yields across the US, Canada, Europe and NZ, where we have positive exposure due to expectations around monetary policy easing, also benefited performance. In contrast, Australian yields rose, highlighting the benefits of having a globally focused duration manager. A global widening in credit spreads driven by the rise in geopolitical concerns had minimal impact on our portfolio given our decision to be more exposed to Australia which widened by less and our exposure to sectors that rallied such as T2 credit. Returns over the past year compare favourably with the current RBA cash rate of 4.35%, hitting the +2-3% performance objective and within the 1.5% volatility limit.* Correlations with other Australian fixed income indices and asset classes are generally below 0.2 over most time frames, continuing to provide strong diversification benefits to many portfolios.** The yield to maturity on the portfolio increased modestly in June, providing a continued strong basis for expected returns looking forward.

Market Commentary

The key global concern to rise in June was the announcement that France would go to an election, which would likely result in the current government coalition losing its majority in Parliament, increasing political uncertainty at best, and raising odds of a larger budget deficit at worst, should the Rassemblement National (far-right party), which gathered over 30% of the votes in the first round on 30th June, gain the majority of seats. The spread between French and German 10 year Government bond yields widened from around 50bps to 80bps, close to its widest level in over a decade but still well below the ~200bps level seen during the European debt crisis in 2011. European credit spreads also widened more than their global peers, out 11bps (Bloomberg Pan European Agg Corporate) over the month and wider by 16bps at the wides intra-month. The contagion spread somewhat to US credit spreads, which were wider by a smaller amount 9bps (Bloomberg US Agg Corporate), although other influences such as dealer repositioning ahead of quarter and financial year end were also present. It's important to keep in mind that this widening occurred from a very low level of spreads and after months of outperformance. Spreads still remain quite low by historical standards.

Above-expectations inflation outcomes also present a threat to fixed income returns. This was most evident in Australia, where warnings from the RBA that disinflation may be stalling combined with above-expectations May inflation data. It's not clear how long the RBA would tolerate core inflation stalling at around 4% before hiking, but in the interim the markets are pricing in hike chances and pushing out the timing of rate cuts. The prospect of rate hikes has pushed up bond yields in Australia in June, when they fell elsewhere. Having a fixed income manager that can choose to avoid any home market bias was therefore crucial in posting strong performance in June.

Yields fell outside of Australia for two reasons: the easing cycle began in Europe and Canada, while US inflation data came out below expectations. Core inflation in both Europe and Canada had fallen to 2.9%, less than a percentage point from target and still declining. This saw the central banks begin to ease back on how restrictive monetary policy needs to be. In the US, a below-expectations inflation number, amidst a backdrop of continued falls in the yearly rate, also sets up a path for rate cuts from the Federal Reserve later in the year. For these reasons bonds generally rallied and took yields lower in the month.

Outlook

Whilst trends were favourable over June as a whole, some clouds loom on the horizon. In particular the higher inflation outcomes were seen in Australia. In Europe and Canada, where the easing cycle has already begun, above-expectations CPI data have called into question whether inflation is still falling. This may see rate cuts occur at least at a slower pace in these regions, if not stall.

While inflation was taking a lower turn in the US, there were also signs that the economy may be softening. Jobless claims have begun to trend higher, despite the strong payroll employment outcomes in recent months. Consumer spending has also been softening over the course of the year. The US election later in the year is likely to see promises of fiscal spending which may provide the economy a boost, but of course the election outcome contains other risks for the economy and markets. Should the US economy falter, then risk markets could suffer. Spreads being at low levels also cautions against being overly exposed to credit markets, but recession fears do not appear imminent for now.

Portfolio Strategy

Exposures in the portfolio were largely unchanged over June, with developments not affecting the key macro themes underpinning our positioning.

Duration positioning was reduced slightly, by 0.1 years to around 1.1 years, only slightly beyond the historical average amount of duration in the portfolio. The mix remains more weighted towards Europe and to a lesser extent Canada, where the central banks have begun their easing cycles on the back of inflation falling towards target. We still maintain an exposure to the US for the same reasons.

The portfolio's physical spread duration reduced slightly to ~1.77yrs, retaining lower sensitivity to spread change than we have historically targeted. We took profits on recent primary issuance after capturing significant spread compression in new issues. Despite the flow of new deals, we saw further credit spread compression especially in Australian T2 deals. Spread performance in the portfolio continued to marginally add to returns over the month driven by allocations to T2 which was a strong outcome given spread widening in global and local credit indices.

The high coupon is currently delivering a level of return stability not seen in nearly a decade driven by a credit spread that is above the average, even though it primarily from shorter-term assets. This leaves us cautiously optimistic about the prospects of short-term investment-grade credit, buoyed by the high coupon.

However, our outlook becomes more cautious when considering longer-term credits, given the current landscape's various peculiarities. Notable among these are the significant losses incurred by Norinchukin, a domestic systemically important bank in Japan; defaults within AAA-rated Commercial Mortgage-Backed Securities (CMBS) in both the US and Europe; and the increasing popularity of more extreme political candidates globally. Under normal circumstances, any of these factors could trigger a 10% drop in equity markets, but the current optimistic market has, partially or completely ignored these issues.

We plan to maintain our spread duration towards the lower range of 1.8 to 2 years, and possibly even shorter in the upcoming months. This will be skewed towards Australian credit because credit spreads in Australia are closer to their long-term averages compared to the significantly tighter spreads observed in the US. Barring a severe global downturn and considering the sustained interest from yield-seeking high-net-worth and Asian investors, we anticipate that Australian spreads will likely play catchup to the US by moving towards the lower end of their historical ranges.

In terms of asset allocation, the portfolio can be split across three major 'buckets'; financials (~58%), corporates and REITs (~25%), and asset and mortgage-backed securities (<15%), with the residual in cash and liquids. Close to ~85% of the portfolio is held in Australian & New Zealand names, and by currency <5% is held in non-AUD denominated securities.

Portfolio liquidity remains high, with 'Level 1' liquidity at ~9% (cash, commercial paper, SSGA) and above the high end of the range for 'Level 2' liquidity at ~25% (<1yr investment grade). We believe the high level of liquidity provides the flexibility to buy attractive credits or take advantage of a better entry point should there be a sell-off.

** Kapstream's flagship and plus funds have placed in the top quartile of Mercer's universe over the past 1, 3 and 5 years as at June 2024, whilst being ranked in the bottom quartile for volatility.*

*** Kapstream has calculated the monthly return correlation with the Australian based indices used in APRA's annual performance test for the Australian superannuation industry and analysed 1yr, 3yr and 5yrs of the Australian indices.*

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